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IN THE

Supreme Court of the United States

October Term, 1974

No. 74-1042

ERNST & ERNST,

Petitioner,

vs.

OLGA HOCHFELDER, et al.,

Respondents.

ERNST & ERNST,

Petitioner,

vs.

LEON S. MARTIN, et al.,

Respondents.

MOTION OF AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS FOR LEAVE TO FILE A BRIEF *AMICUS CURIAE* ON CERTAIN ISSUES AND BRIEF *AMICUS CURIAE*

KENNETH J. BIALKIN
LOUIS A. CRACO
Attorneys for American Institute of Certified Public Accountants
1 Chase Manhattan Plaza
New York, N.Y. 10005

Of Counsel

HOWARD C. BUSCHMAN III
WILLKIE FARR & GALLAGHER
1 Chase Manhattan Plaza
New York, N.Y. 10005

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MOTION OF AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS FOR LEAVE TO FILE A BRIEF *AMICUS CURIAE* ON CERTAIN ISSUES

The American Institute of Certified Public Accountants (the "Institute") hereby respectfully moves, pursuant to Rule 42(3) of the Rules of this Court, for leave to file the attached brief *amicus curiae* in support of the Petitioner in the above-captioned case.[1]

---

[1] Petitioner has consented to the filing of this brief; Respondents' consent has been requested but refused.

The Institute is the only national accounting association whose membership is limited to certified public accountants; it has approximately 110,000 members. Among its purposes is the promotion and maintenance of high professional standards of practice and, in the pursuit of that purpose, the Institute has come to be accepted as the authoritative source of standards and procedures in its field. Most particularly, the Institute develops auditing standards which, after formal approval by vote of its members, are deemed "generally accepted," and which form the backdrop of this litigation.[2]

The Institute has a profound interest in the scope and bases of civil liability for damages sought to be imposed on auditors in connection with their performance of engagements governed by generally accepted auditing standards, under the rubric of Section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. § 78j(b)) ("the 1934 Act") and Rule 10b-5 promulgated by the Securities and Exchange Commission thereunder. In light of that interest, the Institute will confine its brief *amicus curiae* to two related issues of major significance to the accounting profession as a whole:[3]

1. May liability for damages be imposed upon accountants pursuant to Section 10(b) of the 1934 Act and Rule 10b-5 for negligent failure to comply with generally accepted auditing standards in the absence of pleading and proof of *scienter*?

2. May an auditor be liable in damages for aiding and abetting his client's violation of Section

[2] *See, e.g.*, AICPA, STATEMENT ON AUDITING STANDARDS NO. 1—CODIFICATION OF AUDITING STANDARDS AND PROCEDURES (1972); *see also Hochfelder* v. *Ernst & Ernst*, 503 F.2d 1100, 1109-11 (7th Cir. 1974).

[3] The Institute does not express a position with respect to any of the other issues presented by the Petitioner.

10(b) of the 1934 Act and Rule 10b-5 in the absence of knowledge of the client's violative conduct and solely on the basis of negligent performance of audit functions?

The Court below answered these questions in the affirmative. That decision represents a jarring departure from the doctrinal development of the law in the area of securities regulation and imposes unsupportable risks upon the performance of the audit function. The Institute wishes to address in its *amicus* brief certain of the implications of the decision below which transcend the interests of the parties litigant.

In holding that no *scienter* is required to make out a claim for civil damages for aiding and abetting a violation of Rule 10b-5 the Court below either: (a) effected the general repealer of the *scienter* requirement in such cases, in contravention of the carefully balanced statutory scheme of liability reflected by the various securities acts and recognized by the well considered lower court decisions interpreting them; or (b) created the anomaly that aiders and abettors can be exposed to liability under Rule 10b-5 more widely and under a less rigorous standard of proof than those whose direct fraud they are accused of assisting. For auditors, whose liability is almost always secondary to the liability of their clients, the decision and analysis below are thus profoundly disturbing.

Moreover, the Court below, concededly finding no duty at common law to the plaintiff here, and recognizing that no fraudulent misbehavior had been alleged, nonetheless discovered a hitherto unrecognized duty of an accountant to inquire and disclose arising from the duty of its client to file audited statements with the Securities and Exchange Commission. The statutory duty to file thought by the

Court below to create a basis for the auditors' liability here is not different in substance from a vast array of legal provisions requiring many classes of regulated persons to file audited statements. The practical consequences of the rationale adopted below are that a new duty of inquiry, supposedly having statutory or regulatory genesis, appears to have been declared for the auditors of virtually all public companies and that auditors' liability for negligent breach of that duty extends to persons far beyond those to whom runs the duty of the regulated person to file.

This result and the unsatisfactory analysis upon which it was reached impose on auditors unsupportable sanctions in the form of liability of undefined scope and contour by reason of allegedly careless failure to comply with the generally accepted auditing standards promulgated by the Institute. The profession never contemplated that such disastrous consequences could befall auditors for negligent failure to comply with one or more of those standards. The decision announced below thus destroys the balance between the rigor of standards and the consequences of their breach, an equilibrium necessary to any rational and enforceable code of behavior.

These implications are detrimental to the progress of the profession in the development of still higher standards of performance and ultimately to the public interest in full, fair and adequate disclosure of financial information. The Institute seeks leave to file its *amicus* brief to demonstrate that these implications—and others— are not required or

permitted by any correct interpretation of the statute or the rule.

Respectfully submitted,

KENNETH J. BIALKIN
LOUIS A. CRACO
Attorneys for American Institute of Certified Public Accountants
1 Chase Manhattan Plaza
New York, N.Y. 10005

Of Counsel

HOWARD C. BUSCHMAN III
WILLKIE FARR & GALLAGHER
1 Chase Manhattan Plaza
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BRIEF OF AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS AS *AMICUS CURIAE*

KENNETH J. BIALKIN
LOUIS A. CRACO
Attorneys for American Institute of Certified Public Accountants
1 Chase Manhattan Plaza
New York, N.Y. 10005

Of Counsel

HOWARD C. BUSCHMAN III
WILLKIE FARR & GALLAGHER
1 Chase Manhattan Plaza
New York, N.Y. 10005

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CERTIORARI TO THE UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

BRIEF OF AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS AS *AMICUS CURIAE*

Preliminary Statement

The American Institute of Certified Public Accountants (the "Institute") submits this brief as *amicus curiae*, addressed to certain issues specified below, and urges this

Court to reverse the order of the Court of Appeals for the Seventh Circuit, entered on August 30, 1974, reversing summary judgment for the Petitioner previously granted by the District Court for the Northern District of Illinois.

Opinions Below

The opinion of the Court of Appeals is reported at 503 F.2d 1100. The opinion of the District Court is unreported and is annexed to the Petition for a Writ of Certiorari as Appendix B.

Questions Presented

The Institute as *amicus curiae*, addresses this brief solely to the first question presented by the Petitioner in its Petition for a Writ of Certiorari,[1] which in turn analytically divides into the following two related issues:

> 1. May liability for damages be imposed upon accountants pursuant to Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) ("the 1934 Act") and Rule 10b-5 thereunder, 17 C.F.R. § 240.10b-5, for negligent failure to comply with generally accepted auditing standards in the absence of pleading and proof of *scienter*?
>
> 2. May an auditor be liable in damages for aiding and abetting his client's violation of Section 10(b) of the 1934 Act and Rule 10b-5 in the absence of knowledge of the client's violative conduct and solely on the basis of negligent performance of audit functions?

[1] The Institute has not formulated and does not express a position with respect to any of the other issues presented by the Petitioner.

Interest of the Institute as *Amicus Curiae*

The Institute is the only national accounting association whose membership is limited to certified public accountants; it has approximately 110,000 members. Among its purposes is the promotion and maintenance of high professional standards of practice and, in the pursuit of that purpose, the Institute has come to be accepted as the authoritative source of standards and procedures in its field. Most particularly, the Institute develops the auditing standards which, after formal approval by vote of its members, are deemed "generally accepted" and which form the backdrop of this litigation.[2]

The Institute consequently has an obvious interest in the scope and bases of civil liability for damages sought to be imposed on auditors in connection with their performance of engagements governed by such generally accepting auditing standards, under the rubric of Section 10(b).

The implications of the result below, and of the unsatisfactory analysis upon which it was reached, transcend the interests of the parties litigant and are of profoundly disturbing significance to the accounting profession as a whole, as well as to others who perform services for issuers and other participants in securities and financial transactions. The Institute here contends those implications are neither required nor permitted by any correct reading of Section 10(b) or Rule 10b-5.

[2] *See, e.g.*, AICPA, STATEMENT ON AUDITING STANDARDS NO. 1—CODIFICATION OF AUDITING STANDARDS AND PROCEDURES (1972); *see also Hochfelder* v. *Ernst & Ernst*, 503 F.2d 1100, 1109-11 (7th Cir. 1974).

Statement

Petitioner, Ernst & Ernst, was auditor of First Securities Company of Chicago, a Chicago brokerage house ("First Securities"), founded by Leston B. Nay who owned 92% of its stock and served as its chief executive officer. First Securities retained Ernst & Ernst as auditors for each audit of its books and records, commencing in 1946 and continuing through November, 1967.

Plaintiffs alleged that they were customers of First Securities and that, in addition to their regular accounts, Nay had persuaded them to invest in fictitious "escrow" accounts. Nay employed various mechanisms all of which indicated to the escrow investors that the "escrow" accounts were managed, and interest thereon paid to the investors, by Nay personally. Nay's embezzlement of those funds was disclosed in his suicide note.

It is uncontradicted that Ernst & Ernst was not in any way involved in or aware of any of these transactions. The transactions never appeared in the books and records of First Securities. Rather, these transactions were effected wholly separate from First Securities.

Plaintiffs, however, claim that Nay had instituted a "mail rule" prohibiting anyone other than himself from opening mail addressed to him or to First Securities for his attention and they bottom their case on the assumption that Ernst & Ernst, in auditing First Securities, negligently failed to investigate Nay's practice. They argue that if Ernst & Ernst had checked such mail, it would have learned of the escrow accounts, reported them to the National Association of Securities Dealers ("NASD"), the Securities and Exchange Commission ("the Commission") or the Midwest Stock Exchange and that one of those agencies would have taken some action. (Plaintiffs' Answers to Interrogatories 71, 72). Plaintiffs concede that

at no time did they see any audit report by Ernst & Ernst with respect to First Securities or its financial statements. (Plaintiffs' Answer to Interrogatory 79).

In their complaints, Plaintiffs do not charge Ernst & Ernst with intentional fraud or even with knowing of their "escrow" accounts. Moreover, Plaintiffs explicitly concede that they "do not accuse Ernst & Ernst with deliberate intentional fraud." (Plaintiffs' Answer to Interrogatory 74). Rather, they proceed solely on the claim that Ernst & Ernst was negligent in failing to discover the fictional escrow accounts and thus was an aider and abettor of Nay's fraud. They seek damages under Section 10(b) of the 1934 Act and Rule 10b-5.

Discovery has been taken and the issue before this Court arises on Ernst & Ernst's motion for summary judgment, granted by the District Court and reversed below.

Summary of Argument

I

Civil liability for monetary damages on the basis of negligence cannot be properly implied from Section 10(b) or Rule 10b-5. Consideration of the organic language and its history, the structure of the regulatory scheme, the judicial authority over many years and pertinent policy considerations demonstrates that pleading and proof of *scienter* is indispensable to such a private claim against auditors and that the Court below erred in holding otherwise.

The imposition of monetary liability on accountants for negligent auditing finds no warrant in the language of either the act or the rule from which such liability is said

to be implied. The statutory language represents a careful Congressional balancing of interests to distribute liability under the pertinent acts in relation to the nature of the regulated transactions and the position of the regulated person to them. An examination of the legislative history of the 1934 Act and a comparison of the liability provisions of the Securities Act of 1933, 15 U.S.C. §§ 77a-77aa ("the 1933 Act") with the 1934 Act persuasively demonstrate that Congress limited the imposition of explicit liability for damages predicated upon negligence to persons acting in connection with the filing of a registration statement under Section 11 of the 1933 Act and to sellers under Section 12(2) of that Act. In each case such liability was carefully circumscribed by precautions against abuse.

The decision below, imposing liability for negligence upon a secondary person having nothing to do with the securities transactions complained of, running in favor of persons to whom that secondary person owed no duty arising from any relationship between them or from any other previously articulated principle of law, and shorn of any of the protections surrounding the provisions imposing explicit liability under the securities acts, is an obvious anomaly.

The sweep of judicial authority since the implication of a cause of action under Rule 10b-5 in the first place has been overwhelmingly in support of the proposition that such liability turns upon a showing of *scienter*. That has been the holding of the better considered cases in the lower federal courts; and that has been the distinction drawn between actions for monetary damages and suits by the Commission for injunctive relief. Despite ample opportunity to do so, Congress never revised or modified Section 10(b), and the Commission never amended Rule

10b-5, to suggest that the requirement of *scienter* in actions for damages was not to be required. That body of jurisprudence accurately reflects the balance struck by Congress and is persuasive authority here.

Finally, in fleshing out the elements of an implied cause of action under Rule 10b-5 it is entirely appropriate to consider the policy considerations which militate against adoption of the rule espoused below. Such a rule would impose upon accountants unsupportable burdens in the performance of the audit function, would attach to negligent non-compliance with generally accepted auditing standards sanctions in the form of vast monetary recoveries which were never in the contemplation of the profession at the time these standards became generally accepted, would open the door to vexatious litigations brought on the basis of hindsight criticism of the elements of sampling and judgment inherent in the audit process, and would shape a rule of conduct so imprecise and burdensome as to form no useful guide for courts or auditors in the performance of their respective functions. Such open-ended liability predicated upon mere negligence would introduce such unacceptable risks and promote such inhibitions and timidities upon those engaged in financial activities as to interfere with honest business to an extent inconsistent with the policy choices deliberately made by Congress.

II

The decision of the Court below, to the extent that it imports into its analysis the notion that damage liability for "aiding and abetting" a violation of 10b-5 can be based on negligence, compounds the errors summarized above.

"Aiding and abetting", as uniformly used in the law,

requires that the secondarily liable person accord substantial assistance to the known scheme of the principal which is claimed to be unlawful. To impose liability for money damages upon auditors—whose role is almost always secondary to the position of their client—on the basis of negligence would accomplish either the general abolition (criticized in Point I) of the *scienter* requirement or the anomaly that liability could be imposed on the secondary person more widely and upon a less rigorous standard of proof than is required to fix such liability upon his principal. Such paradoxical results are wholly inconsistent with the statutory pattern described in Point I.

Moreover, Congress has specifically focused on the issue of the liability of aiders and abettors and has rejected the imposition of such liability. The Commission, in proposing language to include aiders and abettors within the ambit of the 1934 Act, itself indicated to Congress that such an inclusion would not expose aiders and abettors to liability for monetary damages at all and would expose them to injunctions only on the classic showing of some knowing participation. Congress did not adopt the proposed amendment, regarding it as an unnecessary codification of existing law. The position on this issue of the Commission (which is, of course, the author of Rule 10b-5) and the position of the Congress (which is, of course, the source of Section 10(b)) belie any suggestion that liability for damages on the theory of negligent aiding and abetting can fairly be implied from either the statute or the rule.

The decision below represents an extravagant re-interpretation of a carefully drawn scheme. The rule of law adopted below should be rejected and the serious social costs that would flow from such a rule should be avoided.

ARGUMENT

POINT I

Liability for damages may not be imposed on accountants pursuant to Section 10(b) and Rule 10b-5 for negligent failure to comply with generally accepted auditing standards in the absence of pleading and proof of *scienter*.

This Court is now called upon to consider still another element of the private cause of action for damages which has evolved by judicial interpretation from the proscriptions of Section 10(b) and Rule 10b-5, continuing the process of defining and delimiting its contours that was begun in *Superintendent of Insurance* v. *Bankers Life and Casualty Co.*, 404 U.S. 6 (1971), continued in *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128 (1972), and most recently was the subject of careful consideration in *Blue Chip Stamps* v. *Manor Drug Stores*, 43 U.S.L.W. 4707 (U.S. June 9, 1975) [hereinafter cited as *Blue Chip*]. This time, the issue focuses on whether or not an accountant, claimed to have aided and abetted the fraudulent behavior of his client by the negligent performance of an audit, may be cast in damages by reason of that negligence alone, and absent any charge or proof of *scienter*.[3]

While the case was framed on the theory that Ernst & Ernst had acted as an aider and abettor of Nay's wrong, and while the Court below adverted to this concept in its analysis, the larger question of the requisite *mens rea* to

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[3] The Institute does not express any view as to whether the performance of Ernst & Ernst in the audit of First Securities complied with applicable auditing standards or was negligent in fact. For purposes of this submission the Institute takes as true the well pleaded allegations of the complaint, limited by the concessions in the Answers to Interrogatories, and contends that the showing thus made is insufficient as a matter of law.

make out a damage claim lurks in the Circuit Court's view of the narrower concept of aiding and abetting, and the Institute first addresses that more fundamental issue.

This case poses that issue squarely since the plaintiffs here concededly "do not accuse Ernst & Ernst with deliberate intentional fraud." (Plaintiffs' Answer to Interrogatory 74). Nonetheless, the Seventh Circuit held, on the basis of an analysis discussed more fully below, that a cause of action was well pleaded and that summary judgment could not lie in favor of the accountants.

In this, the Institute contends, the Court below seriously erred. As a matter of law and policy, liability for damages under Section 10(b) and Rule 10b-5 ought not be imposed upon accountants in connection with financial statements audited by them in the absence of a showing of "intent to defraud, reckless disregard for the truth, or knowing use of a device, scheme, or artifice to defraud." *Lanza* v. *Drexel & Co.*, 479 F.2d 1277, 1305 (2d Cir. 1973) (*en banc*).

Noting that Section 10(b) of the 1934 Act does not expressly provide a civil remedy for its violation and that there is no indication that Congress considered "the problem of private suits under it at the time of its passage," *Blue Chip* at 4709, this Court looked to the texts of the 1934 Act and the Rule, to the "extrinsic evidence" of the text of that Act and of the 1933 Act and the scheme reflected by their interrelationship, to the legislative history of their enactment, to subsequent reviews of those Acts, to the body of authority developed by the lower federal courts, and to relevant policy considerations in determining the scope of such liability. A similar analysis here compels the conclusion that, under the regulatory regime of the 1934 Act and Rule 10b-5, liability for damages cannot be imposed on an accountant for bare negligence in performance of an audit.

A. The Text of Section 10(b) and of Rule 10b-5 Is Aimed at Fraud, Not Negligence.

The creation and elaboration of the cause of action for damages under Section 10(b) and Rule 10b-5 is at bottom an exercise in the construction of the language of these provisions themselves. As with any case involving the construction of a statute, the starting point must be the language itself. *Blue Chip* at 4717 (Powell, J., concurring). An examination of both Section 10(b) and Rule 10b-5 discloses an emphasis on fraudulent behavior quite at odds with any suggestion that it was intended to reach negligent conduct.

The critical language of the statute forbids the employment of "any manipulative or deceptive device or contrivance" in contravention of the rules that the Commission may prescribe. And, of course, the Rule's reach may not exceed the grasp of the statute from which it derives its life.[4]

This is the language described in *Blue Chip* as the "legislative acorn" from which grew the "judicial oak" of private damage actions. *Blue Chip* at 4711. It contains no seed of a notion that it was meant to reach neglect as distinguished from fraud, carelessness as distinguished from artifice, mistake as distinguished from misrepresentation. Totally missing is any reference to the exercise of due diligence or reasonable care, or to the proscription of negligence; both the statute and the rule are devoid of any

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[4] Indeed, Judge Friendly has suggested that if the Commission had intended to reach negligence as a basis for the imposition of damages under Rule 10b-5, absent a *scienter* requirement, the provision might exceed the authority vested in the Commission by Section 10(b) to act against manipulative or deceptive devices and contrivances and might "be so inconsistent with the general structure of the statutes as to be impermissible . . ." *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 868 (2d Cir. 1968) (*en banc*), *cert. denied*, 394 U.S. 976 (1969) (concurring opinion).

form of words customarily employed at law to express a formula predicated upon negligence.

Plaintiffs' concession that they do not here charge Ernst & Ernst with knowing or wilful fraud is therefore a concession that they go beyond the explicit terms of the organic statute and rule in their attempt to fashion a claim for damages. As observed by Justice Powell, concurring in *Blue Chip,* however, "Before a court properly could consider taking such liberty with statutory language there should be, at least, unmistakable support in the history and structure of the legislation." *Blue Chip* at 4717. Here, as there, none exists.

B. The Legislative History of the 1934 Act and Extrinsic Evidence from the Texts of the 1933 and 1934 Acts Demonstrate that Congress Intended to Reach Wilful Fraud—Not Negligence—In Situations Like This.

The 1933 Act and the 1934 Act (which itself embraced amendments to the earlier statute) embody a carefully crafted Congressional scheme of regulation governing the issuance and marketing of securities, expertly drawn and elaborately considered. The Acts taken together represent a thoughtful balancing of interests producing a deliberate calculus of liability.

A review of this legislative history and of the structure and interrelationship of the acts persuasively demonstrates two propositions: In the first place, the target of Section 10(b) was fully understood to be fraud in the marketplace. In the second place, it is evident that Congress explicitly imposed liability for negligent behavior only in those narrow classes of situations in which it regarded such liability as necessary to its purpose. In every such case that liability was narrowly circumscribed and subject to protective devices designed to preclude abuse. It will be seen from such a review that Congress had at its command—and used

in appropriate instances—the words of art necessary to impose liability for negligence. Given the careful craftsmanship and scrupulous legislative attention which accompanied the passage of these acts, one can only infer that Congress did not intend liability for negligence to attach when it used words that bespoke fraud, especially since, in those instances, it did not surround its prohibitory language with the precautions attached to those provisions treating of negligence.

1. *The Legislative History of Section 10(b); Target: Fraud.*

As the text of the 1934 Act, already alluded to, shows on its face, the target of Congress in enacting Section 10(b) was deception and manipulation.

The legislative history of Section 10(b) confirms that this was indeed the Congressional objective; it contains no evidence of any intent of Congress to impose liability of any kind for mere negligence. As stated in the Senate Report, explaining the need for legislative action:

> "In addition to the discretionary and elastic powers conferred on the administrative authority, effective regulation must include several clear statutory provisions reinforced by penal and civil sanctions, *aimed at those manipulative and deceptive practices* which have been demonstrated to fulfill no useful function. These sanctions are found in sections 9, 10, and 16." S. Rep. No. 792, 73d Cong., 2d Sess. 6 (1934) (Emphasis added) [hereinafter cited as S. Rep. No. 792].[5]

[5] As part of its attack on such devices, Congress listed several specific items in § 9(a) of S. 3420, 73d Cong., 2d Sess. (1934), and in § 9(b) included a catchall phrase prohibiting such "deceptive devices" which the Commission might declare to be detrimental to investor interests. In the 1934 Act, as finally passed, § 9(b) of S. 3420 and § 9(c) of H.R. 7852, 73d Cong., 2d Sess. (1934), containing substantially the same language, became § 10(b).

Deception is not mere negligence and Congress, in extended discourses in hearings, reports, and public statements repeatedly emphasized its intention to give the Commission power to identify and prohibit fraudulent schemes such as wash sales, matched orders, pools, short sales and the like.[6] As Mr. Thomas G. Corcoran stated:

> "Of course subsection (c) [Section 9(c) of H.R. 7852—later Section 10(b)] is a catchall clause to prevent manipulative devices. I do not think there is any objection to that kind of a clause. The Commission should have the authority to deal with *new manipulative devices.*" *1934 House Hearings* 115 (Emphasis added).

Throughout the discussions of this provision, the words used to characterize its target were those which clearly implied wilfully fraudulent activity: "cunning," "manipulative," "illicit," "fraudulent," "deceptive," "devices," "contrivances."[7]

[6] *See, e.g.*, S. REP. No. 1455, 73d Cong., 2d Sess. 30-55 (1934), for an extended discussion of these fraudulent devices. *See also* the comments of Mr. Thomas G. Corcoran, a draftsman of the Securities Exchange Act of 1934, wherein he characterizes the House Bill (H.R. 7852, 73d Cong., 2d Sess. (1934)) as attacking problem areas of credit control, fraud by insiders and manipulation:

> "Then, we go to the next point, and that is control of manipulations. As I will point out later, there are only a very few real battlegrounds in this act. Manipulation is not one of them. The provisions of this bill, as to manipulations upon stock exchanges, are agreed to practically everywhere. The Dickinson report agrees with them. The Twentieth Century Fund agrees with them. Matched orders, washed sales, pools, options—all of the rest of them are out. So, control of manipulative practices is really not something your committee has to thrash out around this table." *Hearings on H.R. 7852 and H.R. 8720 Before the House Comm. on Interstate and Foreign Commerce*, 73d Cong., 2d Sess. 85 (1934) (testimony) [hereinafter cited as *1934 House Hearings*].

Furthermore, the legislative history clearly shows that Congress was focusing on liability only where the wrongdoer acts in a knowing and purposeful manner. In the hearings of the Senate Committee on Banking and Currency, Mr. Corcoran sought to justify the absence of any language relating to criminal intent in one of the provisions prohibiting manipulative devices. While Mr. Corcoran contended that certain crimes are committed without a specific showing of intent, the committee members were in agreement that while use of the term "intent" was not required, it was clearly necessary to show a specific, knowing purpose to carry out the manipulative device or scheme. Describing the draft language as "clear enough," Senator Pecora (with the apparent approbation of the participating members and Mr. Corcoran) described its effect as, "excluding from its scope an act that is not done with any ulterior motives or purposes, as set forth in the act."[8]

Likewise, in promulgating Rule 10b-5, the Commission showed no intention to impose civil liability in damages for mere negligence. In the words of its author, Rule 10b-5 was designed to close "a loophole in the protections against

[7] *See, e.g.*, H. REP. No. 1838, 73d Cong., 2d Sess. 32 (1934) (Conference Report to accompany H. R. No. 9323, 73d Cong., 2d Sess. (1934)) ("manipulative or deceptive device or contrivance"); *Hearings on S. Res. 84 and S. Res. 56 and S. Res. 97 Before the Senate Banking and Currency Comm.*, 73d Cong., 2d Sess. 6520 (1934) (statement of Mr. Thomas G. Corcoran, "manipulative devices") [hereinafter cited as *1934 Senate Hearings*]; *1934 House Hearings* 21 (statement of Mr. James M. Landis, "other manipulative devices"); *1934 House Hearings* 85 (statement of Mr. Thomas G. Corcoran, "manipulations"); S. REP. No. 792, 6, 12 ("manipulative and deceptive devices," "no useful function," "illicit practices," "guilty party").

[8] *1934 Senate Hearings* 6510.

fraud . . . by prohibiting individuals or companies from buying securities if they engage in fraud in their purchase," SEC Securities Act Release No. 3230 (May 21, 1942), and was prompted by the rather egregious situation where the president of a company deflated its earnings while purchasing its stock. Remarks of Milton Freeman, *Conference on Codification of the Federal Securities Laws*, 22 Bus. Law. 793, 922 (1967). *See Blue Chip* at 4711 (Court opinion), 4720-21 (Blackmun, J., dissenting).

2. *The Extrinsic Evidence from the Texts of the 1933 and 1934 Acts as to the Congressional Scheme Demonstrates that Congress Did Not Intend to Make Secondary Persons Such as Auditors Liable for Mere Negligence in Transactions Not Involving a Prospectus.*

The 1933 and 1934 Acts constitute interrelated components of a federal regulatory regime governing transactions in securities. *Blue Chip* at 4710. The two Acts obviously dovetail in many ways, the 1933 Act providing, for example, for disclosure of material information upon the initial sale of securities through a registration statement and the 1934 Act providing for regulation of exchanges and periodic disclosure with respect to the securities listed thereon. Note, *Civil Liability under Section 10B and Rule 10B-5: A Suggestion for Replacing the Doctrine of Privity*, 74 Yale L.J. 658, 685 (1965).

In construing the elements of civil liability said to arise from the 1934 Act by implication, it is instructive to examine the architecture of civil liability explicitly created by this integrated set of statutes. Congress did not impose such civil liability in damages on an indiscriminate basis. Instead, it made sharp distinctions based on the precise regulatory needs springing from the nature of the transaction and the status of the regulated person in relation

to the transaction. It then circumscribed such liability by a variety of provisions designed to prevent abuse.[9]

It is of special import here that, as to "secondary persons",[10] Congress adopted a standard of liability on a basis that approaches negligence only in the single instance of a misstatement contained in a registration statement, pursuant to Section 11 of the 1933 Act. Even in that case, Congress distinguished between the liability of the issuer and that of accountants who certify the financial statements and do not precipitate the transaction: the issuer is made absolutely liable but the accountants and other persons are liable only on a theory akin to negligence.[11]

Where a registration statement is not involved, Congress provided, in Section 12(2) of the 1933 Act, that

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[9] This Court left open in *Blue Chip* at 4716, n. 15, "the question of whether an implied action under § 10(b) of the 1934 Act and Rule 10b-5 will lie for actions made a violation of the 1933 Act and the subject of express civil remedies under the 1933 Act." To sustain the position of the Court below, this Court would have to reach that question here and decide—contrary to all the available Congressional indicia—that an implied action under the 1934 Act and the Rule can lie upon less rigorous grounds than those established for a civil cause of action under the applicable sections of the 1933 Act.

[10] "Secondary persons", as used in this Brief refers to those who did not engage in face-to-face dealings with the plaintiffs.

[11] Section 11 of the 1933 Act renders an accountant civilly liable for a false registration statement only with respect to that portion of a registration statement which the accountant, as an expert, consented to be included therein. Moreover certain defenses are provided including a "due diligence" defense, which would permit the accountant to prove that he had "after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading." § 11(b)(3)(B)(i) of the 1933 Act.

civil liability can be predicated on negligence [12] only against the seller of the securities and the duty of care imposed on the seller runs only to the buyer in privity with him.[13] Secondary persons are not made liable under Section 12(2) and Congress did not extend civil liability on a negligence basis in situations of alleged misrepresentations by secondary persons. Instead, it enacted specific guidelines pertaining to such liability.[14] These guidelines have a universal theme: an emphasis on good faith as exonerating from liability on the one hand, and wilful fraud or reckless disregard of the truth as necessary to liability on the other.

Thus, when Congress returned to the securities field in 1934, it amended Section 15 of the 1933 Act to provide for exemption from civil liability of a control person if he "had no knowledge of or reasonable grounds to believe in the existence of facts by reasons of which the liability of the controlled person is alleged to exist." Act of June 6, 1934, Pub. L. No. 291, Ch. 404, § 208, 48 Stat. 908, *amending* 1933

[12] That liability is for misleading statements or omissions in connection with the transaction, and the seller is exculpated if he proves that he did not know, and in the exercise of reasonable care, could not have known of the untruth or omission. § 12(2), 1933 Act.

[13] Judicial interpretation has included within the term "seller" certain active and direct participants therein. *E.g., DeMarco* v. *Edens,* 390 F.2d 836 (2d Cir. 1968); *Lennerth* v. *Mendenhall,* 234 F. Supp. 59 (N.D. Ohio 1964). Here, of course, Nay was a "seller" of securities, the escrow notes. Plaintiffs, had they proceeded in timely fashion, plainly could have won rescission from him under § 12(2). Having failed to pursue that express but circumscribed remedy against Nay, with whom they directly dealt, they attempt to fashion an enlarged, implied remedy against Ernst & Ernst, with whom they did not deal at all. Nothing in the statutory regime countenances such a result.

[14] *See* § 15 of the 1933 Act and §§ 9(a)(4), 18 and 20 of the 1934 Act.

Act.[15] Congress similarly addressed the question of civil liability in Sections 9, 16, 18 and 20 of the 1934 Act, carefully distributing and distinguishing liability on the basis of the role played by the defendant in the securities transaction and the demands of protection required. Thus, a broker-dealer, obviously a participant in a transaction, was made civilly liable in damages pursuant to Section 9(a)(4) for any misstatement he made in connection with a securities transaction, "and which he knew or had reasonable ground to believe was so false or misleading." *See also* S. Rep. No. 792 at 12-13. A person or corporation filing reports with the Commission may escape civil liability for a false or misleading statement contained in such filings merely by proving "that he acted in good faith and had no knowledge that such statement was false or misleading." Section 18, 1934 Act.[16]

This points to a careful delineation of three marked distinctions in the varieties of liability-producing actions created by Congress: (1) active participation in the securities transaction itself, (2) mere preparation of documents, such as annual reports required to be filed with the Commission and various Exchanges and made available to the invest-

[15] As Senator Fletcher, the floor leader in the Senate with respect to the securities legislation in 1934, explained with respect to an early draft of this amendment, "The mere existence of control is not made a basis for liability . . ." 78 Cong. Rec. 8669 (1934).

[16] §§ 9 and 18 both provide that suits under those sections must be brought within a maximum of three years. Congress placed the same emphasis on culpability in § 20, precluding liability for control persons if they "acted in good faith and did not directly induce the act or acts constituting the violation or cause of action." § 16 contains no such restraint, it being Congressional policy to prevent gains through purchases and sales of registered stock within a six-month period by control persons. *Blau* v. *Lehman,* 368 U.S. 403 (1962).

ment community, except for a prospectus, and (3) a securities transaction involving a prospectus. Congress made these distinctions and clearly refused to extend civil liability to secondary persons on a basis of mere negligence except possibly in the situation of an initial sale of securities through a registration statement.[17]

These distinctions obviously rest on the Congressional perception of the degree of liability required to enforce adequately its regulatory objective. In this context, for example, a registration statement poses its own special considerations. It is pursuant to a registration statement and the enclosed prospectus that a company first offers its shares to the public or embarks on an expansion by seeking of additional capital from the public. The preparers of a prospectus and the authors of the various statements contained therein, including the accountants who render their certificate as of its effective date, know that the document is to be used as a tool to sell securities and that investors will be given a copy of the prospectus in connection with their purchase. Their work will be employed for the specific purpose of selling securities in a public offering; the need for high standards is evident and the ambit of the duty of due care is definite.

These features separate the registration statement from others and explain the difference between the negligence standard of liability imposed upon the authors of a prospectus pursuant to Section 11 of the 1933 Act and the less demanding standards of "knowledge" set by Section 18 of the 1934 Act for filing a false or misleading state-

[17] Indeed, the first draft of the 1933 Act (H.R. 4314, S. 875, 73d Cong., 1st Sess. (1933)), proposing that the sale of any unregistered security be barred and that any "unsoundness" of the security, regardless of intent, be a test of registration, was quickly shelved by Congress. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 32 (1959).

ment, such as an annual report with the Commission.[18] These considerations, further, are at the root of the analysis by Judge Frank in the seminal case, *Fischman* v. *Raytheon Mfg. Co.*, 188 F.2d 783 (2d Cir. 1951), holding that one who does not fit within the limitations of Section 11 must prove fraud to recover damages under Rule 10b-5.

This conclusion is buttressed by a defense of good faith and failure to induce the violation established by Section 20 of the 1934 Act with respect to a control person, a situation where there is normally no privity. Congress clearly intended to impose liability on the control person who benefits from the scheme; but Congress imposed such liability only on the basis of his knowledge, for it is with knowledge that one may presume that he sought a benefit.

These illustrations serve to support the notion that Congress fashioned standards for liability commensurate with the regulatory needs created by particular transactions and the relationship of the putative defendant to those transactions. They contain nothing that indicates a Congressional intent that liability of indeterminate scope could be imposed for mere negligence and in favor of persons remote from both the auditor and his mistake.

Furthermore, the Congress in expressly distributing civil liability also elaborated a set of conditions, restrictions and defenses coordinated with that liability. The harmonizing of liability and precaution is intrinsic to the statutory scheme and it is appropriate to test the implied liability imposed below by consistency with this pattern.

[18] That it was intended that periodic reports of corporations be governed by the knowledge and good faith standard of § 18 is shown by S. REP. No. 792 at 13 which refers to such reports that are filed with the Commission (as form 10-K requires) as coming under § 18 and states that the defendant "may escape liability by showing that the [false or misleading] statement was made in good faith."

A few examples will suffice to demonstrate that the pattern indeed exists. In the statutory sections creating civil liability for misrepresentations, Congress limited the duration of such liability by short statutes of limitation;[19] provided an explicit right to contribution;[20] guarded against "strike suits" by vesting power in the district courts to require plaintiffs to post security for costs and to assess such costs in favor of defendants;[21] set limits to the classes of persons who could assert a claim, as in the requirement of privity found in Section 12(2) of the 1933 Act; fixed limitations on the measure of damages recoverable, such as the out-of-pocket loss provision under Section 11(e) of the 1933 Act; and made available defenses such as the good faith defense found in Section 18(a) of the 1934 Act.

It is amply clear, then, that, unlike Section 10(b) and Rule 10b-5 where civil liability is not expressly created, "In each case in which civil liability is expressly granted in

[19] § 13 of the 1933 Act provides that an action brought under § 11 or § 12(2) shall be brought "within one year after the discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence" and in any event within three years. § 18 of the 1934 Act provides that actions under those sections shall be "brought within one year after the discovery of the facts constituting the cause of action and within three years after such cause of action accrued." § 9 of the 1934 Act contains similar language. Interestingly, and to the point made in the text, a comparison of these limitations provisions shows that the more onerous the civil liability expressly provided by Congress, the more stringent is the statute of limitations enacted with respect to it. These distinctions were drawn when Congress, in 1934, simultaneously amended these provisions and others in the 1933 Act and passed the 1934 Act. Act of June 6, 1934, Pub. L. No. 291. (Title 1 is the 1934 Act; Title 2 consists of amendments to the 1933 Act). The discriminating relationship of liability and limitations provisions was thus obviously part of the purposeful Congressional pattern.

[20] § 11(f) of the 1933 Act and §§ 9(e) and 18(b) of the 1934 Act.

[21] § 11(e) of the 1933 Act; § 9(e) of the 1934 Act.

either the 1933 or 1934 Act, an express limitation or defense is also included." Ruder, *Civil Liability under Rule 10b-5: Judicial Revision of Legislative Intent?*, 57 Nw. U. L. Rev. 627, 648-49 (1963); *see also* 3 L. Loss, Federal Securities Regulation 1785 (2d ed. 1961).

A rule of liability such as that announced below, predicated upon non-wilful conduct, in favor of an indeterminate class of persons, depending in no way on a close nexus between the plaintiffs' transaction and the defendants' liability-creating act, and bereft of any of the procedural safeguards set out in the acts, is utterly out of harmony with the statutory pattern. Such a discordance should not be accepted. As this Court stated in *Blue Chip* at 4711:

> "It would indeed be anomalous to impute to Congress an intention to expand the plaintiff class for a judicially implied cause of action beyond the bounds it delineated for comparable express causes of action."

And, as Judge Friendly wrote, in dealing with precisely this issue by comparison of Rule 10b-5(2) with the source language contained in Section 17(a)(2) of the 1933 Act[22]:

> "Once it had been established, however, that an aggrieved buyer has a private action under § 10(b) of the 1934 Act, there seemed little practical point in denying the existence of such an action under § 17—with the important proviso that fraud, as distinct from mere negligence, must be alleged. To go further than this, as Professor Loss powerfully argues, Securities Regulation at 1785, would totally undermine the carefully framed limitations imposed

[22] *SEC* v. *Texas Gulf Sulphur Co., supra* at 867-68 (concurring opinion) (citations omitted). See discussion in footnote 13, *supra*.

on the buyer's right to recover granted by § 12(2) of the 1933 Act.''

The Court below took that further step, and its conclusion is patently at odds with the statutory scheme which alone justifies the implication of a private right of action in the first place.

C. A Requirement that *Scienter* be Shown as an Element of a Private Claim for Damages Under Rule 10b-5 Has Achieved Long Standing Judicial Acceptance.

Since a private claim for damages was first implied in *Kardon* v. *National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946), a substantial body of jurisprudence has developed concerning the requisite elements of such a claim. Not surprisingly, attention has been given, explicitly and implicitly, to the state of mind required to fix liability for damages upon a given defendant. That body of jurisprudence reflects an overwhelming consensus that a cause of action for monetary damages under Rule 10b-5 is not made out upon a showing of mere negligence, and that some form of *scienter* is an indispensable ingredient of such a claim.

1. *The Cases in this Court Recognize that Private Claims Under Rule 10b-5 are Based on Fraud.*

This Court has had occasion to consider claims for private damages under Section 10(b) and Rule 10b-5 in *Superintendent of Insurance* v. *Bankers Life and Casualty Co.*, 404 U.S. 6 (1971), *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128 (1972) and *Blue Chip*, although not in the context of facts presented by this case. The cases considered by this Court each involved face-to-face transactions, where the parties litigant were foreseeable and the damage universe was measurable.

While the precise issue argued here was not presented in those cases, their language indicates the degree to which Section 10(b) and Rule 10b-5 were understood to be directed at fraud rather than neglect. Moreover, decisional consequences appeared to have flowed from this Court's understanding that it was dealing with a cause of action for fraud, even though that precise characterization was not the subject of a squarely presented issue. In imposing liability for damages in *Superintendent of Insurance* and in *Affiliated Ute, supra,* the Court was dealing with egregiously fraudulent conduct committed in the context of relatively intimate transactions. The elaboration of other elements of the cause of action and of the character and quality of causal nexus described by this Court as necessary in those cases might arguably have been different if the Court had believed itself to be describing elements of a claim for negligence. Plainly, Congress orchestrated such elements of a cause of action for negligence under Section 11 differently from those arising from wilful fraud, and it is likely that this Court, if it had believed the claim for damages then before it sounded in negligence, would have done the same.

2. *The Better Reasoned Cases Accurately Reflect the Balance Struck by Congress.*

The Court below theorized that an accountant's duty of inquiry could be found from the duty of his client to file certified financial statements and that a breach of that duty and a concomitant duty of inquiry through mere negligence rendered him liable to all those dealing in securities through his client.

This theory is a distortion of the Congressional regulatory scheme and legislative history as outlined above; it is inconsistent with the uniform characterization of the Act and the rule by this Court, and it enjoys no support in the

cases first brought under Rule 10b-5.[23] Other than the Court below, the courts have yet to, in fact, impose liability for conduct solely amounting to mere negligence. *Small-wood* v. *Pearl Brewing Co.*, 489 F.2d 579, 606 (5th Cir. 1974), *cert. denied*, 43 U.S.L.W. 3212 (Nov. 15, 1974); Bucklo, *Scienter and Rule 10b-5*, 67 Nw. U. L. Rev. 562, 568-70 (1972) [hereinafter cited as Bucklo]. With the possible exception of *White* v. *Abrams*, 495 F.2d 724 (9th Cir. 1974) (discussed in footnote 38, *infra*), the farthest any court, other than the Court below, has gone is to state that a defendant in a civil suit for damages "should have known" facts in situations where it was clear that he did know them.

[23] *Kardon* v. *National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946) (corporate insiders failing to make disclosure of known facts when purchasing stock); *Speed* v. *Transamerica Corp.*, 71 F. Supp. 457 (D. Del. 1947) (common law fraud and deceit); *Osborne* v. *Mallory*, 86 F. Supp. 869 (S.D.N.Y. 1949) (fraudulent misrepresentations which induced plaintiff's purchase of stock); *Robinson* v. *Difford*, 92 F. Supp. 145 (E.D. Pa. 1950) (insiders defrauded stockholders by concealing true value of stock purchased from stockholders); *Slavin* v. *Germantown Fire Ins. Co.*, 174 F.2d 799 (3d Cir. 1949) (fraudulent misrepresentations mislead stockholders as to conversion of insurance company into stock company); *Fischman* v. *Raytheon Mfg. Co.*, 188 F.2d 783 (2d Cir. 1951) (fraudulent misrepresentations induced purchases of stock); *Fratt* v. *Robinson*, 203 F.2d 627 (9th Cir. 1953) (majority stockholders defrauded minority stockholders through fraudulent representations).

Moreover, none of the early commentators on the right of action judicially found in Rule 10b-5 ever intimated that the rule would apply to negligent conduct. *See* Latty, *The Aggrieved Buyer or Seller or Holder of Shares in a Close Corporation Under the S.E.C. Statutes*, 18 L. & Contemp. Prob. 505 (1953); Rubin & Feldman, *Statutory Inhibitions Upon Unfair Use of Corporate Information by Insiders*, 95 U. Pa. L. Rev. 468 (1947); Comment, *The Prospects for Rule X-10B-5: An Emerging Remedy for Defrauded Investors*, 59 Yale L.J. 1120 (1950); Note, *Civil Liability Under Rule X-10b-5*, 42 U. Va. L. Rev. 537 (1956); Note, *Implied Liability Under the Securities Exchange Act*, 61 Harv. L. Rev. 858 (1948); Note, *New Civil Liabilities Under Securities and Exchange Act Rules*, 14 U. Chi. L. Rev. 471 (1947); Note, *S.E.C. Action Against Fraudulent Purchasers of Securities*, 59 Harv. L. Rev. 769 (1946); Case Note, 100 U. Pa. L. Rev. 1251 (1952).

While cases can be found which use language consistent with a negligence standard, an analysis of their holdings (summarized in the margin)[24] reflects that such language is

[24] As Bucklo at 581-83 demonstrates, the language employed in *Ellis* v. *Carter*, 291 F.2d 270 (9th Cir. 1961) and *Royal Air Properties, Inc.* v. *Smith*, 312 F.2d 210 (9th Cir. 1962) that Rule 10b-5 would be satisfied by proof that the defendant should have known the facts is *dicta* since the nature of the transaction in *Royal Air* was such that it clearly showed actual knowledge by the defendant, and in *Ellis* the misrepresentation was one of an expression of intent, a matter within the defendant's own knowledge.

Equally *dicta* was the statement in *Stevens* v. *Vowell*, 343 F.2d 374 (10th Cir. 1965) that negligence would suffice because that case involved knowing misrepresentations. *Vowell* is apparently no longer the law in the Tenth Circuit since it, in *Mitchell* v. *Texas Gulf Sulphur Co.*, 446 F.2d 90, 102 (10th Cir.), *cert. denied*, 404 U.S. 1004, *reh. denied*, 404 U.S. 1064 (1971), decreed that "some degree of scienter is required . . . [although] it does not equate with the intent to defraud required in a common law fraud action" and adopted a fraud statute of limitations. Without appreciating the limitations of § 12(2) of the 1933 Act, that Court in *Gilbert* v. *Nixon*, 429 F.2d 348 (10th Cir. 1970), a case brought under both § 12(2) and Rule 10b-5, adopted the § 12 defense as a defense to Rule 10b-5 actions and in *Mitchell*, followed *Gilbert* in that respect. In *Clegg* v. *Conk*, 507 F.2d 1351 (10th Cir. 1974), *petition for cert. filed*, 43 U.S.L.W. 3487 (Mar. 4, 1975), the Tenth Circuit clarified its prior holdings, stating that it never held that negligence would suffice to sustain liability, interpreted its decision in *Stevens* v. *Vowell*, *supra*, to require *scienter*, and thereby removed that prop from those cases relying on *Vowell*.

The Eighth Circuit's statement in *Myzel* v. *Fields*, 386 F.2d 718, 735 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968) that negligence would suffice was also *dicta* since that case involved an appeal from a jury verdict in favor of plaintiff where the district court had charged them that defendants must be proven to be conscious wrongdoers before they could be held liable. Moreover, the statements in *City National Bank* v. *Vanderboom*, 422 F.2d 221 (8th Cir. 1970) and *Vanderboom* v. *Sexton*, 422 F.2d 1233 (8th Cir. 1970), that negligence would suffice are of dubious persuasion since *City National Bank* dismissed the suit on standing grounds and *Sexton* involved merely a selection of the appropriate statute of limitations, a decision followed in *Parrent* v. *Midwest Rug Mills, Inc.*, 455 F.2d 123 (7th Cir. 1972).

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largely *dicta* and that the proposition remains true that no court, until the Court below, imposed liability on facts which demonstrated mere negligence and no *scienter*.

None of the cases articulating a negligence standard comport with the Congressional scheme whereas the cases requiring some form of *scienter* extensively analyze and interpret that history. *Lanza* v. *Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973) (*en banc*); *Kohn* v. *American Metal Climax, Inc.*, 458 F.2d 255 (3d Cir. 1972).

In *Lanza*, the Second Circuit, sitting *en banc* to consider this very issue, reviewed that legislative history and statutory scheme, and canvassed the decided cases. Paying particular emphasis to the problem of the outside director, the Court recognized the distinction between a registration statement and other situations similar to that applicable here, and limited Rule 10b-5 to culpable behavior. 479 F.2d at 1299.[25] The Court concluded its comprehensive review of

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The Seventh Circuit's decision in *Dasho* v. *Susquehanna Corp.*, 461 F.2d 11 (7th Cir. 1972) followed the Second Circuit's opinion in *SEC* v. *Texas Gulf Sulphur Co., supra*, that only negligence need be proven to obtain an injunction. Similarly, *Kohler* v. *Kohler Co.*, 319 F.2d 634 (7th Cir. 1963), stating that knowledge is not required, is a case which did not expressly adopt a negligence standard, and a case where the defendant necessarily knew the facts pertaining to its own financial statements.

[25] Messrs. Sonde and Freedman of the Commission argue that *Lanza* v. *Drexel & Co., supra*, was wrongly decided and conclude that negligence is a proper standard of liability of a director whose corporation is selling shares to the public. Sonde & Freedman, *"Sea Gulls on the Water—Some Ships in a Storm": A Comment on Lanza* v. *Drexel*, 49 N.Y.U.L. REV. 270 (1974). Such a situation is akin to that of a registration statement and the defenses and limitations of § 11 of the 1933 Act should be applied. The *Lanza* Court reflected a wholly proper refusal to judicially overrule § 11 and extend, without any evidence that Congress intended to strike such a balance, its provisions into an area having a tremendous impact on honest business in derogation of its expressed intention to the contrary. H. REP. No. 85, 73d Cong., 1st Sess. 5 (1933).

the authorities on the issue by reiterating the rule of *Shemtob* v. *Shearson, Hammill & Co.*, 448 F.2d 442 (2d Cir. 1971). That decision, held the *Lanza* Court, 479 F.2d at 1304-05:

> "eliminated any doubt that proof of scienter is required in private actions in this circuit. There, in the context of a private action for damages, we stated that no violation of Rule 10b-5 occurs 'in the absence of allegation of facts amounting to *scienter*, intent to defraud, reckless disregard for the truth, or knowing use of a device, scheme, or artifice to defraud. It is insufficient to allege mere negligence.' 448 F.2d at 445. Under the *Shemtob* test, a plaintiff claiming a violation of Rule 10b-5 who cannot prove that the defendant had actual knowledge of any misrepresentations and omissions must establish, in order to succeed in his action, that the defendant's failure to discover the misrepresentations and omissions amounted to a willful, deliberate, or reckless disregard for the truth that is the equivalent of knowledge."

The Institute submits that *Lanza* represents a comprehensive and scholarly analysis of the problem now before this Court, developed by the Court of Appeals for the Second Circuit, sitting *en banc*, and that the rule announced by the Court should have particularly persuasive influence in disposing of the present case.

The Second Circuit is by no means alone in this view. As Judge Adams in *Kohn* v. *American Metal Climax, Inc.*, *supra* (concurring on this point) concluded, after his extensive review of the legislative history of Section 10(b) of the 1934 Act:

> "Essential to the elements intended by Congress are the requirements that the defendant has acted in

> other than 'good faith' and that the plaintiff has 'relied' on the misleading statement. . . . There is no evidence that Congress intended that under Section 10(b) anyone should be an insurer against false or misleading statements made non-negligently or in good faith.'' 458 F.2d at 280.

The Tenth Circuit in *Clegg* v. *Conk, supra,* similarly justified its adherence to some form of *scienter* on the basis of the language of Section 10(b) and Rule 10b-5 and the deception and fraud to which they refer. These cases show a consistent and appropriate concern for the legislative scheme and history and should be accepted here.

The cases requiring *scienter* as an element of a private damage claim do not reflect any lack of concern for the application of such a remedy to new devices created to defraud the public. Cases such as *Lanza, Kohn, Clegg* and *Smallwood, supra,* all demonstrate that the courts are not failing to apply Rule 10b-5 flexibly to prevent and afford redress to the victims of new forms of deception. They have yet to find that adherence to a requirement of some form of *scienter* in damage actions impairs their ability to protect the public in the manner Congress desired.

Apparently, neither has Congress. The rule that a private cause of action for damages requires *scienter* was adopted by the Second Circuit in *Fischman* v. *Raytheon Mfg. Co., supra,* in 1951 long before Congress, with the assistance of the Commission, undertook extensive reviews of the securities laws in 1957, 1959 and 1963.[26] *Fischman*

[26] The Commission proposed amendments to Section 10(b) in 1957 and 1959, both of which failed to pass Congress. *Blue Chip* at 4710. It issued its *Report of Special Study of Securities Markets of the Securities and Exchange Commission,* H. Doc. No. 95, 88th Cong., 1st Sess. (1963). Those events sparked two symposiums.

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went unchallenged in all of those Congressional reviews. Had Congress felt that a requirement of some species of *scienter* was in any way a distortion rather than a recognition of its regulatory scheme, it could have readily legislatively reversed *Fischman.* Failure to do so, even after intensive review of that regulatory scheme, is a still more significant argument that this Court should similarly interpret the statute and rule.[27]

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See, Securities and Exchange Commission Silver Anniversary Commemorative Symposium, 28 GEO. WASH. L. REV. 1, f.f. (1959); *Recent Developments in Securities Regulation: The Special Study of Securities Markets,* 62 MICH. L. REV. 557, f.f. (1964).

[27] Some commentators suggest that the courts adopt the mantle of Congress and rewrite the Congressional scheme. Folk, *Civil Liabilities Under the Federal Securities Acts: The BarChris Case,* 55 U. VA. L. REV. 1, 244 (1969); Note, *Negligent Misrepresentations Under Rule 10b-5,* 32 U. CHI. L. REV. 824, 835-36 (1965). Given the express provisions of other sections of the securities laws, as noted above, and the corresponding silence of Section 10(b) and Rule 10b-5 with respect to the duty to investigate and the other provisions of those sections, Professor Folk has suggested that the courts "harmonize" Rule 10b-5(2) with Sections 11 and 12(2) through adoption of a negligence standard and placing the entire burden of proof on the plaintiff. Folk, *op. cit.* at 244. He submits that such placement of the burden of proof will distinguish Rule 10b-5(2) from those provisions, but says nothing regarding a "harmonization" of the control persons provisions or Section 9(a)4 regarding broker-dealers. He similarly fails to explain how such a "harmonization" would account for the express statute of limitations provided in Section 13 of the 1933 Act or the discretionary requirement of costs provided in Section 11(e). In short, he fails to explain how the river of Rule 10b-5 can rise higher than its source. It has also been argued that it would be logical to incorporate into Rule 10b-5 the various statutes of limitation provided in the express civil liability provisions of the acts as such actions arise under Rule 10b-5. Schulman, *Statutes of Limitations in 10b-5 Actions: Complication Added to Confusion,* 13 WAYNE L. REV. 635, 638 (1967). These exercises in legislative draftsmanship have nothing to do with interpretation of the statute and are best left to Congress. Moreover, the necessity of fashioning such further implications as a correlative to the abolition of the *scienter* rule suggests that the rule itself may have something to be said for it. *Cf. Blue Chip* at 4717.

3. *The Injunction Cases Under the 1934 Act Confirm the Institute's Position.*

A body of jurisprudence has grown up which authorizes the issuance in otherwise appropriate cases of preventive relief, at the instance of the Commission, even in the absence of a showing of fraud involving *scienter*. The cases treating of this subject form no body of precedent for the imposition of liability for damages under the statute and the rule upon an accountant for conduct that is merely negligent. Quite the contrary, the injunction cases themselves recognize the important distinction between equitable relief and damages at law as applied to the culpable state of mind necessary to make out a claim.

For example, this Court, in *SEC* v. *Capital Gains Research Bureau Inc.*, 375 U.S. 180 (1963), reviewed the ancient disparity in the definition accorded to the term "fraud" by equity as distinguished from law in the context of an injunction action brought by the Commission under the comparable section of the Investment Advisers Act of 1940, 15 U.S.C. § 80b-6. The Court concluded on the basis of that analysis that, "It is not necessary in a suit for equitable or prophylactic relief to establish all the elements required in a suit for monetary damages." 375 U.S. at 193. The Court specifically identified an "intention to defraud or to misrepresent", 375 U.S. at 193, as being one element unnecessary to the concept of fraud in equity though a well-established part of the content of fraud in common law cases for damages.

Similarly, in *SEC* v. *Texas Gulf Sulphur Co., supra,* at 866-68, Judge Friendly, in his now classic concurring opinion, sharply drew the line between the propriety of granting injunctive relief under Rule 10b-5 in the absence of proof of *scienter,* which he condoned, and the suggestion

that in actions for damages, *scienter* could be dispensed with, which he condemned.[28]

The decision of the Court of Appeals below rejects this distinction and would impose liability for damages under Section 10(b) and Rule 10b-5 in the absence of any showing of intent to defraud, reckless disregard for the truth, or knowing use of a device, scheme or artifice to defraud, and on an allegation of bare neglience in the discharge of the audit function.

That determination, the Institute contends, is contrary to the plain text of the 1934 Act and the Rule from which the cause of action for damages is sought to be implied, is utterly inconsistent with the carefully crafted structure of the securities acts discussed above and contrary to the substantial body of well considered authorities in the lower courts during the years in which the jurisprudence of private claims under Section 10(b) has been evolving.

The teaching of *Blue Chip* is that such an effort to expand extravagantly the implied cause of action arising under Rule 10b-5 is not consonant with the proper judicial development of the law, and should be rejected.

D. The Policy Implications of the Decision Below are Profoundly Disturbing and Show that it is Improvident.

This Court has recently recognized that, after all is said and done, the contours of a private cause of action under Rule 10b-5 are not fully defined by the intent in 1934 of

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[28] The distinction in the requirement of *scienter* has, of course, become firmly established as an operative principle in the Second Circuit. *Compare, e.g., Shemtob* v. *Shearson, Hammill, supra* and *Lanza* v. *Drexel & Co., supra, with SEC* v. *Texas Gulf Sulphur, supra, SEC* v. *Spectrum, Ltd.*, 489 F.2d 535 (2d Cir. 1973), and with *SEC* v. *Management Dynamics Inc.*, [CURRENT] CCH FED. SEC. L. REP. ¶95,017 (2d Cir. 1975). The latter cases are discussed *infra* at p. 51.

Congress or in 1942 of the Commission. In that circumstance, the Court has held:

> "It is therefore proper that we consider, in addition to the factors already discussed, what may be described as policy considerations when we come to flesh out the portions of the law with respect to which neither the congressional enactment nor the administrative regulations offer conclusive guidance." *Blue Chip* at 4711.

That suggestion is particularly appropriate in this case to the extent that it is arguable that the language of the Congressional enactment or the administrative regulations is inconclusive. An exploration of some of these consequences of particular concern to the accounting profession is persuasive, we believe, in showing that the rule espoused by the Seventh Circuit is utterly improvident and should be rejected.

It is appropriate to begin a review of those policy implications by recognizing that the Court below explicitly departed from the common law duty of accountants as classically defined by Chief Judge Cardozo in *Ultramares Corp.* v. *Touche,* 255 N.Y. 170 (1931). *See Hochfelder* v. *Ernst & Ernst,* 503 F.2d 1100, 1105-08 (7th Cir. 1974). The effect of this departure was to discern a new duty, hitherto undiscovered in the law, running from auditors to persons beyond the ambit of foreseeable users of the statements they certified and based upon neither fraud nor recklessness tantamount to fraud but upon simple negligence in the performance of their audit.

To such a development, the recent observation of this Court in *Blue Chip* is especially pertinent (pp. 4714-15):

> "While much of the development of the law of deceit has been the elimination of artificial barriers

> to recovery on just claims, we are not the first court to express concern that the inexorable broadening of the class of plaintiff who may sue in this area of the law will ultimately result in more harm than good. In *Ultramares Corp.* v. *Touche,* 255 N.Y. 170, 174 N.E. 441, Chief Judge Cardozo observed with respect to 'a liability in an indeterminate amount for an indeterminate time to an indeterminate class' that:
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> > 'The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of the duty that exposes to these consequences.' 174 N.E., at 444."

It is the Institute's point that the hazards to be imposed upon the auditing profession by the terms of the rule announced below are precisely so extreme as to cast doubt on the implication of a duty constructed by the Seventh Circuit by implication from Section 10(b) and Rule 10b-5.

It should be self-evident that the process of auditing the financial statements of a company does not yield absolute certitude about the result. As the chief accountant of the Commission recently observed, in commenting on certain lower court developments, "The 'financial position' is not an absolute which has been precisely defined or is readily apparent."[29]

The audit function proceeds very largely upon the exercise of judgment and by a process of sampling which in turn rests upon the experience, expertise and informed judgment of the auditor. The product of the audit, as dis-

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[29] Burton, *Fairness: Another View,* CHANGING SEC FINANCIAL DISCLOSURE AND ACCOUNTING RULES—1975 (New York Law Journal, 1975).

played in the financial statements is again a matter of judgment. Over the years, the profession has developed the generally accepted auditing standards, not as absolute rules mechanically applicable to every situation, but as guides to the judgment of professionals dealing with actual situations, often of great complexity.

One of those situations arises when the auditor is called upon to satisfy himself as to the adequacy of his client's internal accounting controls, which is the pivotal problem in this case. On this issue, no less than many others involved in the audit procedure, the auditors are required to exercise judgment and to employ sampling. Indeed, the Court below recognized the judgmental character of this task, quoting extensively from the applicable portions of the Statements on Auditing Standards and Procedures promulgated by the Institute and applicable at the time of the audit in question.[30] *Hochfelder* v. *Ernst & Ernst, supra* at 1109-11.

If those tasks, and other similar operations in the course of an audit, are performed by an accountant either with an intent to defraud, or with a wilful, deliberate or reckless disregard for the truth, then the auditor is properly liable under presently articulated legal standards to appropriate plaintiffs for damages he actually causes.

But the consequences of holding that negligence in the performance of such functions may impose civil liability under Rule 10b-5 upon the auditor is, in Judge Friendly's apt word, "frightening".[31]

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[30] AICPA, STANDARDS AND PROCEDURES, STATEMENT ON AUDIT PROCEDURES No. 33, at 11, 16, 28 and 32 (1963).

[31] *SEC* v. *Texas Gulf Sulphur Co., supra* at 866 (Friendly, J., concurring).

The most obvious problem with the negligence standard is that it promotes the commencement of litigations upon a mere charge of a lack of due care in that an auditor has allegedly failed properly to amass or weigh the facts "all judged in the bright gleam of hindsight"[32] with the consequent peril of vast judgments payable to indeterminate numbers of plaintiffs. Such vexatious litigation was one of the policy considerations to which this Court referred at some length in *Blue Chip* as an appropriate constraint on the expansion of private claims under Rule 10b-5. Everything that this Court said there concerning the elimination of the *Birnbaum* doctrine applies with equal force here to the elimination of *scienter* as an element of the claim.

Strike suits predicated on negligence are easy to begin and virtually impossible to end. Brought as class actions they become difficult to try and still more difficult to settle. Irrespective of their merits, they simply do not go away.

During their pendency, the charges leveled against a firm of certified public accountants constitute a cloud on their professional reputation and a threat to their professional standing. The *in terrorem* effect of the pendency of even the most meretricious litigation creates a settlement value in such lawsuits having no relationship to the quantitative size or qualitative merit of the claim.

All of these hazards of vexatious litigation, recognized by this Court to be "different in degree and in kind from that which accompanies litigation in general," *Blue Chip* at 4712, are greatly increased by allowing such litigation to be launched on allegations of negligence alone.

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[32] *Id.* at 867. Cases involving the non-discovery of management fraud rather than misleading financial statements are particularly vulnerable to such hindsight. After the fraud has been discovered, often fortuitously, it is very easy in the light of that discovery to fix upon items which, if fully appreciated earlier, might have provided clues to the fraud. This case, of course, is a classic example of just such second guessing.

To illustrate this point, note that Federal Rule of Civil Procedure 9(b) requires that a complaint bottomed on fraud contain averments setting out the circumstances constituting the fraud with particularity. That requirement of pleading serves the salutary purpose of limiting in some degree the assertion of reckless claims for fraud.[33] No such obligation of particularity exists with regard to a suit alleging mere negligence. If *scienter* is dispensed with and negligence substituted as the governing standard of liability under Rule 10b-5, the risk to accountants and others of reckless assertion of groundless claims, invulnerable to the prophylaxis of Rule 9(b), will be greatly increased.

For this reason, presumably, Congress was scrupulous in establishing safeguards when it created liability under Section 11 of the 1933 Act based on a lack of due diligence. The precautions, fully discussed above, with respect to standing, measure of damages, security for costs, authority to impose such costs upon plaintiffs and statutes of limitation, all are designed to preclude the assertion of groundless claims for negligent misbehavior pursuant to the enabling provision of Section 11. But no such precautions exist with regard to a claim of negligence asserted under Rule 10b-5. The creation of such liability in the absence of such safeguards significantly increases the exposure of accountants to vexatious and harassing litigation in the performance of their audit functions.

This exposure to "large judgments, payable in the last analysis by innocent investors, for the benefit of speculators and their lawyers,"[34] is particularly inappropriate

[33] *See, e.g., Segal* v. *Gordon*, 467 F.2d 602 (2d Cir. 1972); *Matheson* v. *White Weld & Co.*, 53 F.R.D. 450 (S.D.N.Y. 1971); 5 WRIGHT AND MILLER, FEDERAL PRACTICE AND PROCEDURE § 1296 (1969).

[34] *SEC* v. *Texas Gulf Sulphur Co., supra* at 867 (Friendly, J., concurring).

in the case of auditors because auditors generally do not stand to gain from the acts complained of. In the case below, obviously, Ernst & Ernst provided its professional services for a professional fee; Nay's defalcations benefited them not one bit. This is, of course, true in the generality of cases. It is fundamentally unfair to impose upon auditors the risk of limitless liability when the ordinary run of claims which form the grist of cases against them involve no unjust enrichment to them and no participation by them in the alleged despoiling of the investment community.

At this point a further anomaly develops from the rule announced below. The Court of Appeals professed to find the duty of the auditors to inquire and disclose, for the negligent breach of which they could be held liable, in the duty of their client to file audited statements with the Commission. To make out liability against Ernst & Ernst it was sufficient, in the view of the Court, to allege mere negligence in the performance of the audit necessary to such filing. But under Section 18 of the 1934 Act no such relaxed standard of proof would have been applied to First Securities or Nay.

Section 18 of the 1934 Act governs the liability of First Securities as the entity required to file. That provision authorizes a suit by an appropriate plaintiff against a person filing a misleading report under the provisions of the 1934 Act, "unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading." It matters not under Section 18 that the ignorance of the filing person may have been the product of his own negligence, so long as he was ignorant of the misleading character of the statement and acted in good faith. Under the doctrine announced below, however,

no such excuse is available to the auditor of the filing person in this case.[35]

Similarly, Section 20 of the 1934 Act would impose upon Nay, as a control person, liability to the same extent as imposed by Section 18 on First Securities. Thus liability could be found against Nay, the principal culprit below, only upon a showing more rigorous than that which the Court established for the claim against Ernst & Ernst.

The paradox, moreover, is not merely theoretical. It has dangerous practical significance in terms of the ambit of the duty owed, and the range of possible claimants. Section 18 employs the "no knowledge" standard applicable to an expert's opinion at common law fraud.[36] That common law fraud concept, developed and articulated by Judge Cardozo in *Ultramares* only two years before passage of the 1933 Act,[37] had sharply distinguished between fraud

[35] It is also worthy of note that Section 18 includes specific elements of standing, causation, a short statute of limitations, and a provision for security and costs and the imposition of costs against a plaintiff (including attorney's fees), all precautions established by Congress against vexatious lawsuits. These protections, too, are unavailable to the auditors in an action under Rule 10b-5.

[36] Such opinions carry with them an implied assertion that the speaker knows no facts which would preclude his opinion and that he does know facts which would justify it. W. PROSSER, LAW OF TORTS § 109 at 726 (4th ed. 1971). For a complete discussion of *scienter* as that term has become employed in common law fraud, see Keeton, *Fraud: The Necessity for an Intent to Deceive*, 5 U.C.L.A.L. REV. 583 (1958). In *Ultramares Corp.* v. *Touche*, *supra* at 186, Judge Cardozo noted that common law fraud may be made out if an accountant's opinion is made without grounds to support it:

> "Even an opinion, especially an opinion by an expert, may be found to be fraudulent if the grounds supporting it are so flimsy as to lead to the conclusion that there was no genuine belief back of it."

[37] It is noteworthy that Congress expressly changed the rule of *Ultramares* in the prospectus situation of Section 11, under the limitations contained therein. Douglas and Bates, *The Federal Securities Act of 1933*, 43 YALE L.J. 171, 198 (1933). Congress wrote no such modification into the annual report or other periodic filing provisions of Section 18 or into Section 10(b).

and negligence, holding that an accountant was not liable to a third person for negligence unless his services were performed primarily for that third person.[38] As Judge Cardozo stated:

> "In a word, the service rendered by the defendant in *Glanzer* v. *Shepard* was primarily for the information of a third person, in effect, if not in name, a party to the contract, and only incidentally for that of the formal promisee. In the case at hand, the service was primarily for the benefit of the Stern company, a convenient instrumentality for use in the development of the business, and only incidentally or collaterally for the use of those to whom Stern and his associates might exhibit it thereafter. ***Foresight of these possibilities may charge with liability for fraud. The conclusion does not follow that it will charge with liability for negligence.***" 255 N.Y. at 183. (Emphasis added)[39]

The practical consequence of the anomalous holding below, then, is that it abandons—along with the standards of liability in *Ultramares* and its statutory counterpart, Section 18—any rational limitation on the universe of possible

[38] The Ninth Circuit has imported an analogous concept into Rule 10b-5. *White* v. *Abrams*, *supra*. Although adhering to its previous statements that proof of negligence would suffice under Rule 10b-5, it now recognizes that it has yet to apply liability without fault. 495 F.2d at 734. The Court attempted to establish a sliding scale test of culpability dependent upon the relationship of the plaintiff and defendant, the benefit derived by defendant from that relationship, the awareness of the defendant that plaintiff would rely on the relationship and the activity by the defendant in initiating the transaction.

[39] The courts of England have followed suit. Compare *Hedley Byrne & Co. Ltd.* v. *Heller & Partners, Ltd.*, [1963] 2 All E.R. 575 with *Candler* v. *Crane Christmas & Co.*, [1951] 1 All E.R. 426. Lord Justice Denning, in dissent in *Candler* v. *Crane*, *supra* at 436, nevertheless agreed that it would create a "dangerous precedent" to impose a negligence standard unless "it is remembered that it is limited in respect of the persons by whom and to whom it is owed and the transactions to which it applies"—a position adopted in *Hedley Byrne*.

plaintiffs. The total absence of any connection between the plaintiffs in this case and the allegedly mistaken audit forcefully demonstrates the dangerous elasticity of the "duty" divined by the Court below. Its decision truly does create that "liability in an indeterminate amount . . . to an indeterminate class" against which Judge Cardozo warned in the passage from *Ultramares* reiterated by this Court in *Blue Chip*.[40]

To the Institute, as well as to its members, this development of undefined liability to a virtually unlimited class of plaintiffs, shorn of the protections provided in the securities acts, produces yet another grave danger. It was never in the contemplation of the Institute when it proposed, from time to time, its statements on auditing standards, or in the mind of the profession when it accepted them as authoritative, that the negligent failure to observe one or more of their provisions could cast an auditor in damages for such huge sums as are involved here. Neither was it the expectation of the Institute or the profession that these generally accepted auditing standards would provide ammunition for uncontrollable forays by speculative plaintiffs alleging so slim a claim as negligent failure to comply with

[40] The Court below predicated Ernst & Ernst's duty to inquire on the duty of First Securities, as a broker-dealer, to file SEC Form X-17A-5, which in turn required that the financial statements included therein be certified. There appears to be no logical basis for limiting the implications of the Court's decision below to broker-dealers or to Form X-17A-5. There is a vast array of other forms which regulated persons must file with the Securities and Exchange Commission under the provisions of the applicable statutes and rules and which specify that the financial statements included therein must be certified. For example, under the 1933 Act, SEC Forms S-1, S-2, S-3, S-4, S-5, S-6, S-7, S-8, S-9, S-11, S-16 and materials pursuant to Regulation C; under the 1934 Act, Forms 10, 10-K, 11-K, 8-K, and materials pursuant to Regulation 14-A; and under the Investment Company Act of 1940, Forms N-80-2, N-5 and N-8B-1.

The implications of the rationale of the Court below for accountants engaged in the audit of public companies are, as a very practical matter, truly frightening.

their terms. Eliminating *scienter* as a requirement for a 10b-5 claim against an auditor destroys the equilibrium between the rigor of the rule and the consequence of its breach which is indispensable to any rational and enforceable rule of behavior. The erosion of that balance in turn has obvious and deleterious implications for the ability of auditors to perform their functions, and the ability of the profession to articulate progressively higher standards of audit performance, free from the risk of disproportionate liability.

All these social costs were overlooked or dismissed by the Court below. They represent precisely the kind of adverse policy considerations that Congress could, and presumably did, weigh in the balance in formulating its scheme of liability in the 1933 and 1934 Acts. This Court is entitled to consider the gravity and severity of such social costs in determining whether the unprecedented sweep of liability authorized by the Court below should be announced as the law of the land.

The Institute submits that no advantage to the investing public requires the imposition of such significant costs and that no canon of interpretation of Section 10(b) or of Rule 10b-5 warrants this Court in creating liability of such scope.

POINT II

Liability for damages may not be imposed upon an accountant for aiding and abetting his client's violation of Section 10b-5 in the absence of knowledge of the client's violative conduct and solely on the basis of negligent performance of auditing functions.

The Court below characterized Ernst & Ernst as a negligent aider and abettor of Nay's fraud and on that

ground, held it liable for damages supposedly sustained by plaintiffs as a consequence of Nay's embezzlement.

It is unclear what the Court below believed was added to its analysis by acceptance of the plaintiffs' concept of aiding and abetting.[41] If the Court intended to hold that *scienter* was not a necessary ingredient of the implied claim for damages under Rule 10b-5, its disposition was error for the reasons assigned in Point I, and the theory of aiding and abetting in no way overcomes the theoretical and practical difficulties in the way of such a rule. If, on the other hand, the Court considered the doctrine of aiding and abetting as an independent source of liability for the accountants, its holding is palpably wrong as a matter of law and defies the most elemental notions of common sense and common fairness.

As a matter of law, the concept of a negligent aider and abettor who is ignorant of his principal's scheme, is simply unknown to the law, has been rejected by every other court to consider the question, runs afoul of the Congressional regulatory scheme and poses grave consequences for accountants and other professionals. As a matter of common sense and elemental justice, if aiding and abetting is thought to constitute an independent ground for recovery against the accountants here, it incongruously exposes such secondary persons to liability under Rule 10b-5 more widely and under a less rigorous standard of proof than those whose direct fraud they are accused of assisting. For auditors, whose liability is almost always secondary to that of their clients, such a result is egregiously unfair.

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[41] It may be that, faced with a nearly impossible task of articulating a causal relationship between the accountants' error and the plaintiffs' injury, the Court, like the plaintiffs, resorted to "aiding and abetting" to bridge that doctrinal gap. The concept contributes nothing to the validity of the Court's analysis of the requisite *mens rea*.

A. Liability for Negligent Aiding and Abetting a Violation of Section 10(b) or Rule 10b-5 Is Contrary to Every Indication of Legislative Intent.

The concept of a negligent aider and abettor employed below suggests the imposition of monetary liability on persons who may not have known of the allegedly deceptive scheme, might have refused to participate in it had they known of it, and who never intended through conduct or silence to assist it. Congress never intended such an imposition and has given every indication that such a theory should be rejected.

The securities laws obviously contain no language rendering an alleged aider and abettor liable for damages under Section 10(b) and Rule 10b-5. Indeed, the numerous distinctions enacted by Congress in providing for civil liability under the 1933 and 1934 Acts discussed in Point I, *supra*, imply strongly a disavowal of any such intention. It would be paradoxical indeed to hold that Congress, having structured such an elaborately interrelated set of liability provisions, intended at the same time to override the distinctions inherent in them by means of an unexpressed and unenacted concept of negligent aiding and abetting.

The thesis of the Court below that a secondary person could be liable for negligently aiding and abetting the principal wrongdoer's fraud is thus contrary to the text and legislative history of the 1933 and 1934 Acts in general and of Section 10(b) in particular for the reasons already fully briefed. Even more pointedly, any such theory was specifically rejected by Congress in its subsequent review of that legislation.

In 1959, the Commission proposed that an aiding and abetting section be added to both the 1933 and 1934 Acts

to establish a statutory base for the proposition that an aider and abettor may be liable [42] to administrative sanctions or injunctive relief at the suit of the Commission under those sections not containing an express imputation of such liability. In support of the bill, the Commission's General Counsel urged that since an aider and abettor was liable for criminal penalties under 18 U.S.C. § 2, Congress should make him answerable under the same standards in injunctive proceedings or administrative proceedings. *Hearings before a Subcommittee of the Senate Committee on Banking and Currency,* 86th Cong., 1st Sess. 275-6 (1959) [hereinafter cited as *1959 Senate Hearings*].

The SEC Staff noted a precise and for our purposes decisive limitation on the proposal—that it excluded a private right of action against an aider or abettor for civil damages. *Id.* at 288.

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[42] The only statutory authority for aiding and abetting a violation of Section 10(b) and Rule 10b-5 then and now is contained in 18 U.S.C. § 2 which subjects an aider and abettor to the same criminal punishment as a principal.

H.R. 5001, 86th Cong., 1st Sess. (1959) and S. 1178 would have added a new Section 29 to the 1933 Act, providing:

"Associated Persons"

"Sec. 29. It shall be unlawful for any person indirectly, or through or by means of any other person, to do any act or thing which it would be unlawful for such person to do directly under the provisions of this title or any rule or regulation thereunder. It shall be unlawful for any person to aid, abet, counsel, command, induce, or procure the violation of any provision of this title or any rule or regulation thereunder by any other person. These provisions shall not constitute a limitation with respect to the applicability to this title of section 2 of title 18, United States Code."

The same language would have been added to Section 20 of the 1934 Act. *Hearings before the House Committee on Interstate and Foreign Commerce,* 86th Cong., 1st Sess. 93, 103 (1959). Language making aiders and abettors liable to injunctive relief was reintroduced in the Second Session of the 86th Congress in 1960 as S. 3770.

The Staff submission first described what it did seek to accomplish by the enactment:

> "The new section does not limit the application of the criminal aiding and abetting statute of the United States Judicial Code. Rather the amendment borrows the concept of aiding and abetting from the criminal law and seeks to insure that persons will be liable in civil administrative actions by the SEC, as well as in criminal actions." (*Ibid.*)

The Staff then recited an objection that it regarded as serious:

> "In addition, the industry fears that private litigants, not only the SEC, may find in this section a vehicle by which to sue aiders and abettors. For the statute does not say who can sue—it merely says 'it shall be unlawful' (to aid or abet). The courts have extended from the SEC to private plaintiffs a right of suit under a comparably general antifraud provision of the 1934 Securities Exchange Act (sec. 10(b))."

The submission then concluded, reciting as "Suggestions of industry agreeable to SEC" only the following:

> "—Make it clear that no civil liability is intended." (*Ibid.*)

This episode is highly significant. In proposing the amendment, the Commission's General Counsel Staff stopped far short of the negligence theory adopted by the Court below and urged that the standards of *criminal* aiding and abetting be applied to its intended objective. *1959 Senate Hearings* at 275-76. Those standards were expressed by this Court in *Nye & Nissen* v. *United States,*

336 U.S. 613 (1949), adopting and approving the time honored language of Judge Learned Hand in *United States* v. *Peoni,* 100 F.2d 401 (2d Cir. 1938). That language requires knowledge of, deliberate association with, and intent to make the scheme succeed, not negligence:

> "It will be observed that all these definitions have nothing whatever to do with the probability that the forbidden result would follow upon the accessory's conduct; and that they all demand that he in some sort associate himself with the venture, that he participate in it as in something that he wishes to bring about, that he seek by his action to make it succeed." 100 F.2d at 402.[43]

Congress did not adopt the proposed amendment, regarding it as an "unnecessary" codification of existing

[43] Since Congress expressly retained only 18 U.S.C. § 2 as the only statutory base for aiding and abetting liability we note that it is universally held that to establish criminal liability as an aider and abettor, there must be proof that the defendant gave sufficient assistance or encouragement (through action or inaction) to the principal wrongdoer with knowledge of the wrongdoer's actions and with the intent to further his scheme. *Nye & Nissen* v. *United States, supra; United States* v. *Peoni, supra;* LaFave and Scott, Criminal Law § 64 (1972). No court has relaxed the requirement that the criminal aider and abettor have actual knowledge of the scheme. As held in *United States* v. *Newman,* 490 F.2d 139, 142 (3d Cir. 1974), such actual knowledge is clearly required by 18 U.S.C. § 2, for that statute expressly states that one who "aids, abets, counsels, commands, induces, or procures" the commission of an offense is liable as a principal and clearly presupposes that one knows that which he is assisting. That requirement of knowledge was retained in Tentative Draft No. 1 of the ALI Model Penal Code, § 2.04(b). There, the drafters suggested that the criminal intent standard be relaxed, but they retained the requirement of actual knowledge. This draft has not been approved, however, by the American Law Institute and the official draft of the Model Penal Code, § 2.06, requires both knowledge and criminal intent to further the crime to sustain an allegation of aiding and abetting.

law. S. Rep. No. 1757, 86th Cong., 2d Sess. 9 (1960). So stating, it recognized that knowledge and intent were the appropriate standards for liability under a theory of aiding and abetting.[44] The unwillingness of even the Commission to suggest that statutory authority be granted to impose civil liability in damages against an aider and abettor, coupled with the retention of the standards of actual knowledge and intent, strongly indicate Congressional unwillingness to attach civil damage liability under any lesser theory of liability. *Cf. Blue Chip* at 4710; *Blau* v. *Lehman,* 368 U.S. 403, 413 (1962).[45]

[44] In support of the amendment, the Commission noted, moreover, that in *SEC* v. *Time Trust,* 28 F. Supp. 34, 43 (N.D. Cal. 1939) an analogy was drawn to the criminal provisions of 18 U.S.C. § 2 as setting forth the standards applied to grant a civil injunction and further cited *Otis & Co.* v. *SEC.,* 106 F.2d 579 (2d Cir. 1939) in support of its position. *1959 Senate Hearings* at 247, 275. In *Otis & Co.,* the court affirmed a grant of an injunction sought by the Commission for violation of § 17(a) of the 1933 Act (which was incorporated in all respects material here, in Rule 10b-5), for purposely inflating the market in a security, not negligence.

[45] Indeed, this legislative history shows Congressional rejection of any civil liability in damages as an aider and abettor under Rule 10b-5 at all—a rejection the Court below and this Court should not ignore. *See Flood* v. *Kuhn,* 407 U.S. 258, 284 (1972). In *Brennan* v. *Midwestern United Life Ins. Co.,* 259 F. Supp. 673 (N.D. Ind. 1966) the Court claimed that it could ignore Congress' failure to enact an aiding and abetting section to cover Section 10(b) and Rule 10b-5 because it claimed that it could not determine the reasons for such inaction, citing *Wong Yang Sung* v. *McGrath,* 339 U.S. 33, 47 (1950) and *Helvering* v. *Hallock,* 309 U.S. 106, 119-120 (1940). As noted, Congress fully set forth its reasons. Moreover, neither of those cases stands for the proposition cited. *Wong Yang Sung* held that the court can interpret a statute in a particular way even though Congress failed to clarify an ambiguity. *Helvering* held that Congressional failure to overrule a prior decision by this Court did not preclude this Court from refusing to follow it. Here, there is no statute, no ambiguity and no prior decision.

B. The Courts Have Uniformly Rejected Imposition of Damages on an Aiding and Abetting Theory In the Absence of Knowledge of the Offending Scheme.

The thesis of the Court below, that an aider and abettor may be liable in damages where he had no knowledge of the scheme alleged to violate the law is unique to this case and has been universally rejected.

Other than the panel below, the courts have adhered to requirements of knowledge and intent in cases seeking to fix liability in damages under Rule 10b-5 on a theory of aiding and abetting.[46]

While these cases have not examined Congress' refusal to extend aiding and abetting concepts to Section 10(b) and Rule 10b-5, the courts deciding them all required knowledge of the wrongful scheme as an essential element of the cause of action as an aider and abettor. Thus, the Second Circuit in *Lanza* v. *Drexel, supra,* reached that result through extensive review of both the 1933 Act and the 1934

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[46] *See, e.g., Zabriskie* v. *Lewis,* 507 F.2d 546 (10th Cir. 1974); *Kerbs* v. *Fall River Indus. Inc.,* 502 F.2d 731 (10th Cir. 1974); *SEC* v. *Coffey,* 493 F.2d 1304 (6th Cir. 1974); *Lanza* v. *Drexel & Co., supra; SEC* v. *North American Research & Dev. Corp.,* 424 F.2d 63 (2d Cir. 1970); *Brennan* v. *Midwestern United Life Ins. Co.,* 417 F.2d 147, 154-55 (7th Cir. 1969), *cert. denied,* 397 U.S. 989 (1970); *Rosen* v. *Dick,* [CURRENT] CCH FED. SEC. L. REP. ¶94,786 (S.D.N.Y. 1974); *SEC* v. *National Bankers Life Ins. Co.,* 324 F. Supp. 189 (N.D. Tex.), *aff'd,* 448 F.2d 654 (5th Cir. 1971); *Wyndham Associates* v. *Bintliff,* ['66-67 Transfer Binder] CCH FED. SEC. L. REP. ¶92,016 (S.D.N.Y. 1967), *aff'd,* 398 F.2d 614 (2d Cir.), *cert. denied,* 393 U.S. 977 (1968).

In *Trussel* v. *United Underwriters, Ltd.,* 228 F. Supp. 757 (D.C. Colo. 1964), the Court held that gross recklessness was equivalent to knowledge.

For an extensive analysis of the Rule 10b-5 aiding and abetting cases, see Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification, and Contribution,* 120 U. PA. L. REV. 597, 620-38 (1972).

Act and by extrapolating Congressional purpose with respect to Section 11 of the 1933 Act to Section 10(b) and Rule 10b-5. The Seventh Circuit in *Brennan* v. *Midwestern United Life Ins. Co., supra,* made no such analysis but rested its holding on a finding of knowledge coupled with "calculated silence". 417 F.2d at 153-54. The Tenth Circuit in *Zabriskie* v. *Lewis, supra* at 554, required such a finding to preclude potential liability for purely coincidental actions.

Indeed, other than the Court below, the farthest any court has gone is in *SEC* v. *Management Dynamics Inc., supra* and *SEC* v. *Spectrum, Ltd., supra.* These cases hold that recklessness can be a proper base upon which to issue an injunction against an aider and abettor. These cases expressly note, however, that a grant of prophylactic relief is founded on principles entirely different from those applicable to actions for damages. Thus, in *Spectrum* the Court emphasized that a standard of negligence "should not be construed to apply to more peripheral participants in an illicit scheme or, for that matter, to criminal prosecutions or private suits for damages." 489 F.2d at 542. In *Management Dynamics,* the same Court noted that injunctive suits lie in equity, not law, and required proof of recklessness before an injunction would issue.

This combination of "long standing acceptance by the Courts" of such standards coupled with recognition by Congress and the Commission that they neither needed nor had provided any civil damage liability against aiders and abettors all argue "significantly in favor of acceptance of [such standards] by this Court." *Blue Chip* at 4710; *see also Blau* v. *Lehman, supra* at 413.

In case such considerations were not dispositive, the theoretical underpinning of the implied cause of action un-

der Rule 10b-5 further confirms that result. The principal base for such a right of action in damages is the tort theory attaching such civil consequences to a violation of law. *Kardon* v. *National Gypsum, supra* at 513; Ruder, *Civil Liability Under Rule 10b-5, supra* at 630-35.

The Court below, however, in applying a negligence theory of aiding and abetting, distorted that tort theory, for at common law, defendants acting in concert are liable only when they do exactly that: act in concert. PROSSER, LAW OF TORTS, *supra* at 291-292. It is universally held that such liability requires knowledge of the alleged scheme and participation in it. *Ibid.* Thus, THE RESTATEMENT OF TORTS § 876 (1939) provides:

> "876. Persons Acting in Concert
>
> For harm resulting to a third person from the tortious conduct of another, a person is liable if he
>
> (a) orders or induces such conduct, knowing of the conditions under which the act is done or intending the consequences which ensue, or
>
> (b) knows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other so to conduct himself, or
>
> (c) gives substantial assistance to the other in accomplishing a tortious result and his own conduct, separately considered, constitutes a breach of duty to the third person." [47]

Subsections (a) and (b) expressly require knowledge of the tortious consequences and, as the comment to subsection (c) makes clear, that subsection presupposes knowledge of the scheme and association with it, in addition to a separate breach of duty owed by the alleged aider and abettor to the third person.

[47] The concept of the breach of duty to "the third person" imports into this argument the observations concerning the proper ambit of the accountant's duty set out in Point I.

The Court below, however, jumped from the duty of the auditor's client to file audited statements with the Commission to find a duty of the accountant, dismissed the requirement of knowledge, and held that the duty of the accountant as an alleged aider and abettor ran to these plaintiffs. This convolution runs totally afoul of tort theory requiring knowledge, not negligence, for such liability. The duty described by the Court below does not arise from any language to be found in the text of Section 10(b) or Rule 10b-5 and there is not a scrap of legislative history that indicates that Congress ever sought to impose such a duty on the accountant from the mere obligation of his client to make periodic disclosure.[48] Moreover, the holding below that these plaintiffs were the beneficiaries of that alleged duty to disclose is squarely contrary to tort theory, as set forth in *Ultramares,* limiting the class of beneficiaries of such a duty to persons whose use of the financial statements was foreseeable. The duty described below is also at odds with the statement of this Court in *Affiliated Ute Citizens* v. *United States, supra* at 151-52, that a duty of disclosure arises under Rule 10b-5 where one is an active participant in a securities transaction, and not where he merely renders assistance.[49]

Absent knowledge, one can only unwittingly assist; he does not abet the scheme by joining with it. That distinc-

[48] In *Wessel* v. *Buhler,* 437 F.2d 279, 283 (9th Cir. 1971), the Ninth Circuit implicitly held that no such duty arises.

[49] *See also SEC* v. *Coffey, supra,* where the Sixth Circuit held that a theory of aiding and abetting Rule 10b-5 violations requires knowledge that the violation would be furthered by conduct of the aider and abettor.

tion was made clear long ago by the Supreme Court of California in *People* v. *Dole,* 122 Cal. 486, 492, 55 P. 581, 584 (1898) in a case still cited today:

> "A person may aid in the commission of an offense by doing innocently some act essential to its accomplishment, and this is especially true in regard to the crime of forgery, for he may pass the forged instrument without knowing that it is forged. The word 'aid' does not imply guilty knowledge or felonious intent, whereas the definition of the word 'abet' includes knowledge of the wrongful purpose of the perpetrator and counsel and encouragement in the crime."

The Court below stood this doctrine on its head by holding an accountant liable as an aider and abettor for *failing to know* of the alleged scheme. It thereby subjected the auditors to liability for another's fraud when they never knew of it and did not elect to participate in it. This ruling leaves at peril any professional who performs services for a client without encyclopedic knowledge of its affairs. Such a result is totally contrary to tort theory, Congressional intent, the case law, the universal view of the commentators, and to President Roosevelt's exhortation in submitting the 1933 Act to Congress "to protect the public with the least possible interference to honest business."[50]

In short, the Court below was seriously and dangerously wrong. Its order should be reversed.

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[50] Letter from President Roosevelt to Congress, March 29, 1933, reprinted in H. REP. No. 85, 73d Cong., 1st Sess., 1, 2 (1933).

CONCLUSION

The order of the Court of Appeals for the Seventh Circuit should be reversed.

Respectfully submitted,

KENNETH J. BIALKIN
LOUIS A. CRACO
Attorneys for Amicus Curiae,
American Institute of Certified Public Accountants
1 Chase Manhattan Plaza
New York, New York 10005

Of Counsel

HOWARD C. BUSCHMAN III
WILLKIE FARR & GALLAGHER
1 Chase Manhattan Plaza
New York, New York 10005

Certificate of Service

The undersigned affirms that on the 27th day of June, 1975, a copy of the foregoing Motion of American Institute of Certified Public Accountants for Leave to File a Brief *Amicus Curiae* on Certain Issues and Brief *Amicus Curiae* was served on each of the attorneys for Petitioner and Respondents at the addresses listed below by depositing in the United States mail the same enclosed in an envelope with adequate postage thereon.

FRANCIS D. MORRISSEY, Esq.
130 East Randolph Drive
Chicago, Illinois 60601

DONALD L. VETTER, Esq.
135 South LaSalle Street
Chicago, Illinois 60603

WILLARD J. LASSERS, Esq.
Elson, Lassers & Wolf
11 South LaSalle Street
Chicago, Illinois 60603

WILLARD L. KING, Esq.
King, Robin, Gale & Pillinger
135 South LaSalle Street
Chicago, Illinois 60603

LEON M. DESPRES, Esq.
77 West Washington Street
Chicago, Illinois 60602

.....

Louis A. Craco
Attorney for American Institute of Certified Public Accountants